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For Immediate Release, October 6, 2006
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Middle-class Ohioans would pay more under flat-tax proposal

Forty-five percent of Ohioans would end up paying higher taxes while only 30 percent would see taxes lowered, based on an analysis of the details available on gubernatorial candidate Ken Blackwell's plan for a flat 3.25 percent income tax. Meanwhile, the richest Ohioans would reap thousands of dollars on average in annual tax savings apiece when the plan is fully implemented, and the state would lose more than $800 million a year in revenue.

The top 1 percent of Ohio taxpayers, those making more than $295,000 a year, would on average save $13,805 a year. Meanwhile, those in the middle fifth of the income spectrum – making between $30,000 and $46,000 a year – would see an average annual tax increase of $187. Because of a temporary rate freeze, no one would pay more immediately under the Blackwell plan. However, a single-rate tax when fully phased in would make middle-income Ohioans pay more, so upper-income Ohioans could pay less.

Those were among the findings of an analysis by the Institute on Taxation and Economic Policy (ITEP), a nonprofit, nonpartisan research group in Washington, D.C., with a sophisticated model of the state and national tax systems**.** The report, which updates an earlier analysis of a plan that would have exempted fewer taxpayers, was released today by Policy Matters Ohio.

The analysis compares a fully implemented 3.25 percent tax with the state income tax as if all of the five-year, 21 percent tax cut the Ohio General Assembly approved last year had been fully phased in. It also retains tax credits and exemptions as written in existing law, with one exception: The current credit that allows those earning $10,000 a year or less after exemptions to pay no Ohio income tax is revised and increased to assure that tax filers earning $20,000 or less after exemptions would not pay taxes.

How we measured the cut

The impact of any Ohio income tax proposal depends on what an analyst measures it against. Tax changes enacted in 2005, which would be accelerated under the Blackwell plan, are scheduled to drop the top Ohio income tax rate from 7.5 percent to 5.925 percent by 2009 (and will drop the bottom tax rate from 0.743 percent to 0.587 percent). This already-enacted change means that the additional benefit from any future income tax cuts will be less and less as time goes on. A flat-rate 3.25 percent tax will benefit fewer and fewer Ohioans as the already-enacted income tax cuts phase in, so the only way to accurately measure the impact of the Blackwell plan is to review its long-term impact. For this reason, we have measured the impact of the flat tax compared to the "fully-phased-in" income tax rules as enacted by the legislature last year.

This assumes that those earning more than $20,000 after exemptions will be taxed on their full taxable income, and that married filers with income between $20,000 and $40,000 who currently file jointly will continue to do so. Over time, many couples who currently file jointly would have an incentive to file separately under this system.

This analysis represents our best attempt to analyze the Blackwell proposal based on the information made available so far. It does not attempt to examine the impact of the flat-tax plan during its phase-in period, as there are numerous unanswered questions that make such an analysis impractical. For example, the plan as released says that four brackets in the current graduated tax will be removed, without identifying them. It does not say exactly how long the phase-in period will be, or whether the exemption from taxes for those filers earning under $20,000 would take place immediately or in phases. Nor does it identify whether all taxpayers would retain existing deductions and credits when the plan is fully implemented.

What is clear, however, is that middle-income taxpayers will pay more under a single-rate flat tax when fully phased in. Overall, 45 percent of Ohioans would pay more in state income taxes if this flat-tax proposal were enacted, while only 30 percent would pay less. The remainder would see no change in their income-tax liability. The table below shows how such a tax cut would affect Ohio taxpayers at different income levels:

Impact of a Flat 3.25% Income Tax on Ohio Taxpayers
All Ohio Taxpayers, 2005

2005 Income Group	**Lowest 20%**	**Second 20%**	**Middle 20%**	**Fourth 20%**	**Next 15%**	**Next 4%**	**Top 1%**
Income Range	Less Than $17,000	$17,000 to $30,000	$30,000 to $46,000	$46,000 to $71,000	$71,000 to $128,000	$128,000 to $295,000	$295,000 Or More
Average Income in Group	$10,000	$23,000	$38,000	$57,000	$91,000	$180,000	$762,000
Tax Change as a % of Income	**-0.3%**	**0.2%**	**0.5%**	**0.2%**	**–0.2%**	**–0.9%**	**–1.8%**
$ Average Tax Change	**-$26**	**+$42**	**+$187**	**+$139**	**-$145**	**-$1,593**	**-$13,805**

Source: Institute on Taxation and Economic Policy, October 2006

This flat tax would reduce annual Ohio tax collections by $848 million. However, many Ohioans would have to pay higher federal taxes because they would have less state income tax to write off on their federal returns. The $848 million state tax cut under this plan would be partially offset by $277 million in federal income-tax increases for those who itemize on their federal forms. That would leave a net tax cut of $571 million for Ohioans from this plan—even though Ohio revenues would decline by the full $848 million. The Blackwell release says that the plan will result in a $1.2 billion tax cut. However, it is unknown if this number is the cut under a fully implemented plan, or what baseline is being used to make the comparison. A larger figure than the $848 million in our analysis would almost certainly result if the plan is measured against 2005 taxes rather than the long-term tax structure, but that would measure the cut against yesterday's tax system, not the actual one.

State Tax Cut	-$848 million
Federal Tax Increase	+$277 million
Net tax change	-$571 million

Another recent report from Policy Matters Ohio found that the size of a state's public sector is not correlated with private-sector economic growth (See *State Economic Growth and the Public Sector*, September 2006, http://www.policymattersohio.org/state_economic_growth_2006.htm). Nor do states with lower state and local tax levels have higher per capita personal income or gross state product. This undercuts the notion that a tax cut resulting from a flat, 3.25 percent tax would provide Ohio with economic gains.

Flat-rate income taxes remain very much the exception among U.S. states. While only six states have flat-rate income taxes, 35 states and the District of Columbia have income taxes with graduated rates.

Policy Matters Ohio (www.policymattersohio.org) is a nonpartisan, nonprofit research institute with offices in Cleveland and Columbus. ITEP's Microsimulation Tax Model allows it to measure the distributional consequences of federal and state tax laws and proposed changes in them, both nationally and on a state-by-state basis. A description of the tax model can be found on ITEP's web site, www.itepnet.org.